

TARANTO & ASSOCIATES, CPA's  
PO BOX 5332  
CLINTON, NJ 08809  
908-730-7211

# CPA Client Tax Letter

Tax Saving and Planning Strategies from your Trusted Business Advisor<sup>SM</sup>

## Planning During Uncertain Times



Some of the tax laws that were passed in the early years of this century will expire after 2010. Next year, prior law could take effect. Alternatively, Congress may pass new tax laws effective in 2011—or even some laws that are retroactive to the beginning of 2010. Therefore, tax planning for year-end 2010 is unusually challenging.

The articles in this issue of the *CPA Client Tax Letter* are based on current law, as of this writing. However, Congress may act by year-end, changing current law substantially. Therefore, our office will keep you posted to let you know what changes, if any, have been signed into law and how they might affect your personal tax planning.

### Income tax

In 2010, six federal income tax rates exist, ranging from 10% to 35%. Current

law calls for five tax rates to be in effect for 2011, from 15% to 39.6%. As you can see, such a change would increase tax obligations for many people. In that case, year-end tax planning might suggest accelerating income into 2010, to pay tax at lower rates, while deferring deductions until 2011 when higher tax rates might make deductions more valuable.

The Obama Administration has proposed keeping 2010 tax rates for most taxpayers; only those with income over \$200,000 (\$250,000 for married couples filing joint returns) would face higher rates. As some lawmakers have pointed out, though, such a limited increase might do little to reduce the federal budget deficit. Therefore, Congress could decide to increase tax rates for people earning \$150,000; \$100,000; or even less. On the other hand, some federal legislators have suggested keeping the tax rates of 2010 in effect for another year to help stimulate the economy.

In addition, many specific income tax breaks expired after 2009. For example, you could deduct sales tax in 2009 but not in 2010. Congress may pass a so-called “extenders” bill that would reinstate those tax breaks for 2010. Such a bill, if passed, could lead you to change your year-end strategies.

*continued on page 2*

October/November/  
December 2010

## What's Inside

### SPECIAL ISSUE: 2010 Tax Planning Roundup

- 1 Planning During Uncertain Times
- 2 Year-End Tax Planning for Investors
- 3 Year-End Tax Planning for Mutual Funds
- 4 Year-End Tax Planning for IRAs
- 5 Year-End Tax Planning for Itemized Deductions

CPA

America Counts on CPAs®

## Estate tax

The federal estate tax has not been in effect for deaths occurring in 2010. Some lawmakers have announced their intention of reinstating the estate tax for 2010, but such an effort, if successful, would be controversial, to say the least. The deeper in the year we go before any change in estate tax law happens, the less likely it becomes that the federal estate tax will be retroactively instituted for 2010.

Regardless of how deaths in 2010 are treated, it's highly probable that the federal estate tax will be back in effect for deaths in future years. Under current law, the estate tax exemption in 2011 would be only \$1 million. If that happens, many estates would owe federal tax, based on the value of the decedent's home, investments, life insurance, and so on.

Some Senators and Representatives have suggested increasing the exemption amount to \$3.5 million, the same as it was in 2009. Others would like to see an even larger exemption, perhaps \$5 million. Lawmakers also are debating the issue of "portability": the idea of allowing a surviving spouse to use any remaining federal estate tax exemption that was not fully used by the first spouse when he or she died.

Estate tax rates also are on the table. In 2009, the last year this tax was in effect, the top rate was 45%. Under current law, the top rate will be 55%, plus a 5% surtax for very large estates. Some people in Congress favor bringing the rate down to 45% and others would go even lower. Any revisions in the federal estate tax rules also would affect the gift tax and the generation-skipping transfer tax.

With far-reaching changes in tax law likely to pass in late 2010, feel free to contact our office periodically to keep up with legislative developments. Once the situation has clarified, we can help you accomplish two key goals: determining whether your estate plan needs to be updated and getting timely ideas for year-end income tax savings. ■

## Your CPA Client Tax Letter Has a New Look!

Welcome to the first issue of the redesigned *CPA Client Tax Letter*. Please enjoy its contemporary look and full color images. We're happy to hear your feedback!

## Year-End Tax Planning for Investors

For the past two years, investors have experienced extraordinarily tumultuous times. From late 2008 through early 2009, stock markets in the United States and around the world have fallen sharply. The S&P 500 Index, a leading benchmark for the U.S. stock market, lost about half of its value, for example.

As the winter of 2009 came to a close, stocks rebounded. For the remainder of last year and into early 2010, stocks enjoyed one of the strongest recoveries since the 1930s. Investors who held on recouped some of their losses, and those who timed the market successfully had sharp gains.

During the second quarter of 2010, however, stocks dived again. Debt woes in Europe and sluggish employment growth in the United States discouraged investors. As

of this writing, the outlook for the balance of 2010 is uncertain.

The bottom line? Depending on your investment history, you may have a mix of gains and losses in your portfolio, short term or long term. To make savvy trades by year-end, a careful review of your holdings in taxable accounts should be done to see exactly where you stand.

### Capital gain concerns

In 2010, most taxpayers owe tax at 15% on long-term capital gains. Certain low-income taxpayers have a 0% tax rate. Under current law, the 0% rate would be eliminated, and the 15% rate would move up to 20%.

The Obama Administration has proposed that the 0% and 15% tax rates be retained; only high-income taxpayers (those with income over \$200,000, or \$250,000 on a joint

return) would owe 20% tax on long-term gains. At present, no one knows how capital gains will be taxed in 2011.

How can you proceed? The following are suggested strategies for minimizing taxes.

### Take losses

If you own securities in your taxable account that are trading at levels below your purchase price, you can sell them before year-end. Such trades will provide capital losses. At year-end, those losses can offset the capital gains tax on any profits you have taken. If you have excess losses for the year, up to \$3,000 can be deducted from your ordinary income. Excess losses can be carried over to future years with no time limit.

**Example 1:** Jim Bell takes \$11,000 worth of capital gains during 2010 and \$19,000 worth of

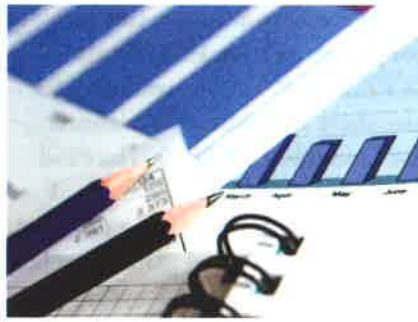
capital losses. Therefore, he has a net capital loss of \$8,000 for the year. Jim takes a \$3,000 deduction on his 2010 tax return and carries over \$5,000 of losses for use in the future.

After you sell securities at a loss, wait at least 31 days before repurchasing them. The capital loss won't count if you buy them back too soon. If you are concerned about being out of the market for that time period, you are allowed to buy a similar but not identical security right away.

### Take gains

After taking losses in taxable accounts, go over your holdings for which you have a paper profit. Do you intend to sell them soon, either for investment reasons or to raise cash? If so, you can sell them in 2010, tax free, up to the amount of your net capital losses for the year.

**Example 2:** Meg Clark tallies her gains and losses for 2010 in early December. She discovers that she has net capital losses of \$6,000 so far. Meg intends to sell \$30,000 of ABC Mutual Fund shares in early 2011 to raise money for her daughter's college bills. At current prices, Meg would have a \$5,000 gain on the sale. Meg can sell those shares in 2010, tax free, because her gains would be more than offset by her net capital losses. She'll have a



\$1,000 net loss for the year, after taking \$5,000 of tax-free gains, and she can deduct that \$1,000 net capital loss on her 2010 tax return against her ordinary income.

What if Meg also has a \$10,000 paper profit on XYZ Mutual Fund, and she expects to sell those shares in 2011? Should she sell those shares in 2010, too? If she does, the first \$1,000 of gains will be offset by her net capital loss and the other \$9,000 will be taxed; however, Meg will lock in the gain and owe tax at only 15%.

If Meg expects her taxable income in 2011 to be well over \$200,000, taking those gains in 2010 might make sense. Even if her income will be lower, she may want to take gains this year if she fears that tax rates will increase and she'll owe 20% or more on a sale in 2011.

Yet another tactic: Meg could give some of her XYZ shares to her widowed mother, Karen, whom Meg is helping to support. Then Karen

could sell those shares in 2010. As long as Karen's taxable income remains under \$34,000 for the year, she will owe 0% tax on long-term capital gains. At year-end, our office can help you make those types of sell, hold, or giveaway decisions.

### Looking backward

As mentioned previously, you can deduct up to \$3,000 worth of net capital losses on your tax return and carry forward excess losses to future years. Therefore, you should check your 2009 tax return to see if you're carrying forward any unused capital losses. You'll find that information on Schedule D of Form 1040. If you have such losses from the 2008 bear market or prior years, you can take gains to soak them up without paying any taxes out of pocket.

**Example 3:** Louis Ward has \$20,000 worth of loss carry-forwards from previous years. He hasn't taken any capital gains or losses this year. If Louis generates \$17,000 in net capital gains by the end of 2010, his loss carry-forwards will offset the tax on those gains. He can deduct the remaining \$3,000 of net loss against his 2010 ordinary income, reducing his existing taxable income for the year and his resulting tax obligation. ■

## Year-End Tax Planning for Mutual Funds

If you invest in mutual funds, proceed cautiously at year-end. At this time of year, funds may distribute any net capital gains for 2010 to their shareholders. These distributions are taxable to investors (unless the fund is held in a tax-favored retirement account), and the share price typically drops to reflect the distribution.

**Example 1:** Caitlin Carter invests \$10,000 in Mutual Fund ABC in

early December 2010. She acquires 500 shares at \$20 apiece. One week later, ABC makes a \$2-per-share capital gain distribution, and the share price drops to \$18. Caitlin owes tax on a \$1,000 capital gain distribution (\$2 per share × 500 shares)—even though the distribution is essentially a return of her own money. Therefore, if you are going to invest in a mutual

fund between now and December 31, 2010, you may be better off waiting until after any distribution. You might be able to avoid this tax trap and buy at the post distribution reduced trading price. Check the fund's website for information about capital gain distributions; if the fund won't distribute capital gains because of bear market losses, you can buy at a time of your choosing.

*continued on page 4*

If you are thinking of selling mutual fund shares, on the other hand, you may decide to advance your plans if you learn that your fund will make a capital gain distribution.

**Example 2:** Steve Davis invested \$10,000 in Mutual Fund XYZ many years ago. He now owns 700 shares of the fund, trading at \$25, for a total of \$17,500. Steve wishes to take his gains in 2010

while the maximum tax rate on long-term gains is 15%. On the XYZ website, Steve sees that a \$3 per share distribution is planned for December 15, 2010. The fund estimates that \$2.50 per share of that distribution will be in the form of short-term capital gains from last winter's rally. Thus, if Steve holds onto his shares, he will receive a distribution of \$2,100 ( $\$3 \times 700$

shares), most of which will be taxed in his 28% ordinary income tax bracket as short-term capital gains.

Instead, Steve sells before XYZ's distribution. With a \$10,000 cost basis and a \$17,500 selling price, Steve will have a \$7,500 long-term gain, all of which will be taxed at only 15%. ■

## Year-End Tax Planning for IRAs



Through 2009, you could convert a traditional IRA to a Roth IRA only if your modified adjusted gross income (for the year) was no greater than \$100,000 on a single or joint tax return. The \$100,000 cap came off in January 2010. Under current law, this change is permanent. Therefore, high income taxpayers can convert traditional IRAs to Roth IRAs in 2010, 2011, 2012, and so on. For taxpayers who would like to convert their traditional IRA to a Roth IRA, year-end 2010 presents multiple opportunities.

**Example 1:** Wendy Ames has \$200,000 in her traditional IRA that contains only pretax dollars. Wendy would like to invest in a Roth IRA because these accounts may permit tax-free withdrawals in the future, and Roth IRA owners don't have to take required distributions. Also, if she wishes, Wendy can leave her Roth IRA intact for her beneficiaries, who will have to take scheduled distributions but will owe no tax as long as the account is at least five years old.

### Crafting a conversion

If Wendy is debating whether to convert her traditional IRA to a Roth IRA in 2010 or wait until 2011 or later, a 2010 conversion offers several advantages:

- 1. Lower taxes.** Although Wendy will owe tax on the amount she converts, in this example, her traditional IRA has a much lower value now than it did in 2007 because of stock market declines. Therefore, a Roth IRA conversion now would generate a lower tax obligation than it would have created three years ago.
- 2. Lower tax rates.** A 2010 conversion also will lock in this year's income tax rates, which might be higher in the future.
- 3. Faster tax-free withdrawals.** Roth IRA withdrawals are tax-free after five years and after age 59½. By converting in late 2010, Wendy will start the five year clock for tax-free withdrawals at January 1, 2010.
- 4. Future flexibility.** Taxpayers who convert to a Roth IRA in 2010 have a unique choice. In this example, Wendy can report the taxable income from her 2010 Roth IRA conversion on her 2010 tax return. Or she can take advantage of a special rule for 2010 conversions and report half of the income on her 2011 tax

return and the remaining half on her 2012 return, thus obtaining a period of tax deferral.

- 5. Surtax relief.** Starting in 2013, some high-income taxpayers will owe a 3.8% surtax on investment income. (See the third quarter 2010 issue of the *CPA Client Tax Letter* for further details.) If Wendy converts her traditional IRA to a Roth IRA, she will not have to make required minimum distributions in the future, and she may reduce her taxable portfolio to pay the income tax on her Roth IRA conversion. Consequently, Wendy might have lower gross income and lower taxable investment income in future years, which could reduce her exposure to the 3.8% surtax. Wendy can gain this advantage with a Roth IRA conversion in 2011 or 2012 as well, but a 2010 conversion also will provide the other advantages on this list.

### Taking action

Some taxpayers may choose to convert by year-end 2010 because they will have a chance to reverse their conversion. All Roth IRA conversions can be recharacterized by October 15 of the following year (October 17 in 2011); the account would revert to a traditional IRA, and the taxpayer

would receive a refund of any tax paid on the conversion.

**Example 2:** Tim Bradley decides to convert his \$100,000 traditional IRA to a Roth IRA in late 2010 to take advantage of a low IRA balance and today's relatively low tax rates. He pays the tax on \$100,000 of income with his 2011 tax return. In October 2011, Tim sees that his Roth IRA is worth \$125,000. He decides to leave his Roth IRA in place, with \$25,000 of tax-free growth in the account.

**Example 3:** Assume the same facts as in example 2, except that Tim's Roth IRA has declined to \$80,000 by October 2011. He recharacterizes the account to a traditional IRA and files an amended tax return for a refund. After waiting at least 31 days, Tim

can reconvert this traditional IRA to a Roth IRA. If the account value has not changed materially in the interim, Tim will owe less tax on this Roth IRA conversion than he owed on his 2010 conversion.

### Be prepared

Taxpayers who are considering a Roth IRA conversion in the last quarter of 2010 should take the following steps:

- First, evaluate the benefits of converting your traditional IRA to a Roth IRA. If you are concerned that upper income individuals and couples will pay much higher taxes in the future, you may want to convert your tax-deferred traditional IRA to a tax-free Roth IRA.
- Second, if you would like to have a Roth IRA, decide how much you

are willing to convert. If you do a partial conversion, you will reduce your tax obligation.

- Finally, if you decide to convert your traditional IRA to a Roth IRA and you have determined how much you'd like to convert, notify the custodian of your traditional IRA in advance. There may be a rush to convert to Roth IRAs at the end of 2010 as many taxpayers seek to take advantage of the benefits mentioned previously. By notifying your IRA custodian in advance about your plans, you may be able to get your paperwork ready for a Roth IRA conversion in late 2010. If you or a loved one face a similar decision, our office can help you make an IRA plan that's appropriate for your specific circumstances. ■

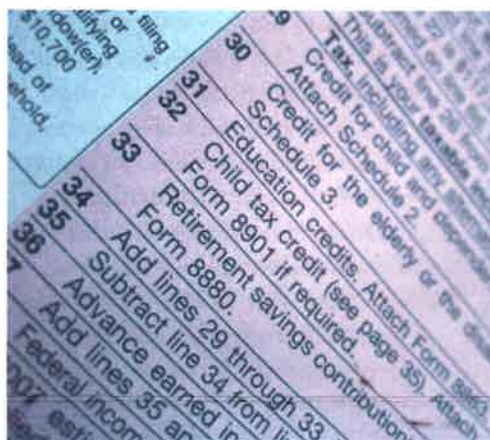
## Year-End Tax Planning for Itemized Deductions

When you fill out your tax return for 2010, you'll have to choose whether to itemize deductions or claim a standard deduction. If you itemize, you'll deduct certain amounts you spent this year on charitable donations, mortgage interest, and so on.

You may, instead, claim a standard deduction. For 2010, the standard deduction is \$11,400 for married couples filing a joint return; \$5,700 for singles and married individuals filing separately; and \$8,400 for heads of household. Taxpayers who are over age 65 receive an additional standard deduction: \$1,400 for single taxpayers and \$1,100 apiece for married taxpayers in 2010. Similar deductions are available to the blind. If you qualify on both counts, you'll get two deductions.

### Possible tax break

For 2010, you may need to consider another possibility when you decide whether to itemize or take the



standard deduction. In previous years, homeowners could deduct up to \$500 of property tax paid, in addition to their standard deduction (married couples could deduct up to \$1,000). This tax break expired after 2009, but Congress is considering a bill to extend it into 2010, as of this writing. Regardless of how Congress acts on this issue, if you itemize deductions instead of taking the standard deduction, you generally can deduct all the property tax you pay.

### Making the choice

As year-end nears, you can determine whether you will be better off itemizing or taking the standard deduction this year. If you think you'll take the standard deduction, you may want to defer itemized deductions until 2011, when you might get a tax benefit.

**Example 1:** Wallace and Diane Franklin are both 66 years old. They own their home without a mortgage and

pay \$2,000 per year in property tax. The Franklins expect to pay around \$4,000 in state income tax this year. They have not had significant unreimbursed medical expenses. So far this year, they have not made substantial charitable contributions.

If the Franklins decide to take the standard deduction, their total will be either \$13,600 or \$14,600, depending on whether the real estate property tax break has been extended.

*continued on page 6*

Standard deduction for all couples filing jointly	\$11,400
Additional deduction for married people 65 and older	2,200
Special property tax deduction (if available)	1,000
<b>Total</b>	<b>\$14,600</b>

If the Franklins decide to itemize, their deductions would include only \$4,000 in state income tax and \$2,000 in property tax—\$6,000 total. Thus, in this example, they would be much better off taking the standard deduction. Therefore, the Franklins probably should delay their usual year-end charitable contributions until January 2011 because they might save tax in 2011 by itemizing deductions. In contrast, taxpayers whose itemized deductions clearly will top the standard deduction amount generally should incur itemized deductions, such as charitable contributions, in 2010. Some taxpayers who owe the alternative minimum tax (AMT) will save tax by itemizing, even if their standard deduction exceeds their itemized deductions. Our office can help you decide.

### Healthier deductions

You can take steps to increase your deductions for 2010, if you decide to itemize rather than take the standard deduction. For instance, you can figure out whether you are likely to deduct medical costs this year. You can deduct such costs only to the extent they exceed 7.5% of your adjusted gross income (AGI).

**Example 2:** Melody Neale expects her AGI this year to be around \$100,000. Thus, she'll be able to deduct health care expenses over

\$7,500: 7.5% of \$100,000. When Melody tallies her medical outlays for the year, she finds she already has spent \$10,000, so she is over the threshold. She can go to the dentist, get doctors' checkups, buy prescription eyeglasses, and so on before December 31 and pay those bills with tax-deductible dollars.

On the other hand, suppose Melody's health care expenses are only \$4,000 for the year, through November. She can decide to postpone all elective medical procedures until 2011, when they might lead to tax deductions.

### Make the most of miscellany

You should approach miscellaneous itemized deductions in the same manner. Such deductions include outlays for tax preparation, unreimbursed employee business expenses, investment expenses, Roth IRA losses, and 529 college savings plan losses. You add up all of those items and take deductions to the extent they exceed 2% of your AGI.

**Example 3:** Gary Roberts expects his AGI this year to be around \$150,000. Therefore, he'll be able to deduct miscellaneous itemized deductions over \$3,000: 2% of \$150,000. As of early December, Gary finds that his miscellaneous deductions for 2010 are already at \$4,000; thus, further expenses will be deductible. Before year-end, he can pay for investment publications and software with tax-deductible dollars. If Gary closes out his sole Roth IRA and sole 529 account for losses this year, those losses also will be deductible on his 2010 tax return.

On the other hand, if Gary has only a few hundred dollars in miscellaneous costs in 2010, he

may decide to incur additional miscellaneous costs in 2011, when they might be more valuable.

### Adjusting for the AMT

Your strategies for itemized deductions will be different if you are subject to the AMT. Increasingly, moderate and upper income taxpayers owe the AMT in addition to regular tax; our office can tell you if you will pay the AMT this year. Taxpayers who are subject to the AMT can deduct medical costs only to the extent those costs exceed 10% of AGI, rather than 7.5% of AGI. Therefore, your decision on whether to incur elective medical bills by year-end will be based on whether they'll be greater than 10% of your AGI, not 7.5%.

If you are subject to the AMT, you won't be able to take miscellaneous itemized deductions, no matter how much you spend. Therefore, if you will owe the AMT this year, you shouldn't close out Roth IRAs or 529 college savings plans at a loss because you won't get any tax benefit. Instead, wait until next year to see if those tax-favored accounts recover—or if you'll escape the AMT in 2011 and perhaps be able to deduct miscellaneous expenses.

Just as you can't take miscellaneous itemized deductions for AMT purposes, you also can't deduct state and local tax payments. Taxpayers who itemize deductions may decide to prepay in 2010 any property tax or state and local income tax due in early 2011 to get a current deduction. However, if you will owe the AMT in 2010, you might as well wait until those tax payments are due in early 2011 because you might be able to deduct them on your 2011 return. ■